332.1
Am351c
cop.2

CLEARING HOUSE EXAMINATIONS BY CLEARING HOUSE EXAMINERS

DISCUSSION LED BY

MR. J. B. FORGAN

OF CHICAGO

AT MEETING OF THE CLEARING HOUSE SECTION, AMERICAN BANKERS' ASSOCIATION, AT LOS ANGELES, CALIFORNIA, THURSDAY, OCTOBER SIXTH, NINETEEN HUNDRED AND TEN

Clearing House Examinations By Clearing House Examiners

The above caption appeared under the head of Discussions in the program of the meeting of the Clearing House Section, at Los Angeles, October 6, 1910.

The following gentlemen took part in the discussion, which is herein reprinted.

J. B. FORGAN
President First National Bank, Chicago, Ill.

SOL. WEXLER
Vice-President Whitney-Central National Bank, New Orleans, La.
President of the Section

E. SHORROCK
President Northwest Trust and Safe Deposit Co., Seattle, Wash.

STODDARD JESS
Vice-President First National Bank, Los Angeles, Cal.

R. T. FORBES
President First National Bank, St. Joseph, Mo.

J. THRALLS
Manager Kansas City Clearing House Association, Kansas City, Mo.

CHARLES K. McINTOSH
Vice-President San Francisco National Bank, San Francisco, Cal.

A verbatim report of the meeting is included in the Book of Proceedings of the Thirty-sixth Annual Convention of the American Bankers' Association.

35841

332.1
Am351c
copy 2

Digitized by the Internet Archive
in 2016

https://archive.org/details/clearinghouseexa00amer

Clearing House Examinations by Clearing House Examiners

MR. J. B. FORGAN, CHICAGO

Gentlemen: You are doubtless all aware that the examination of banks under clearing house authority was first inaugurated in Chicago. It may interest you to know just what brought it about.

Three banks—one national and two State—under the management and control of one man had failed. Up to this time banks connected with the Clearing House Association were only required to render to the Clearing House Committee copies of their statements made five times a year to the Comptroller of the Currency or to the Auditor. These statements besides the balance sheet, give the amount of past due or suspended paper, a list of the liabilities of directors and officers or of firms or corporations in which they are interested, a list of bonds carried and a list of excessive loans.

When the associated banks took over the assets of these three failed banks and paid their deposits it was found that notwithstanding Government examinations, which disclosed the true conditions, the statement of the national bank, which alone had clearing house privileges, did not disclose a correct list of bonds carried or a true statement of the excessive loans or of the president's personal liabilities to the bank. These were hidden by a novel practice of putting through fictitious loans on memorandum notes with names written on them (all in the same handwriting) of parties who had nothing whatever to do with the transactions and were ignorant of their existence. These notes were made out for $90,000 each and attached to them were $100,000 of the bonds of a railway company owned and controlled by the president of the bank. The loans were really personal to him, and the aggregate of them should have appeared as an excessive loan, or if the bonds were sold to the bank at 90 per cent. of their face value they should have appeared in the list of bonds. In either case the Clearing House Committee would have been informed of their existence in the bank; but by splitting them up into numerous fictitious loans of $90,000 each, which was within the bank's legal limit, they became merged into the aggregate of loans current and no special attention was drawn to them in the statements rendered. This practice had been permitted by the Comptroller's department to go on for years, and while there was a suspicion in our community that the president must be using the funds of the bank in his different outside ventures there was never anything

in the statements rendered to the clearing house that would indicate that such was the case, so that our suspicions were allayed. As you are aware, the Chicago banks heroically took over the assets of the three banks and paid off their deposits at considerable loss to themselves.

Clearing house examinations in Chicago grew out of this incident. We determined to know for ourselves the actual condition of all the banks associated together in the clearing house. The first thing to do was to get a competent man to undertake the work. We were very fortunate in discovering the right kind of man. We did not hamper him with any hard and fast rules or arbitrary instructions. We simply adopted the policy that he with sufficient assistants should make examinations of the bank and report on the conditions found by him in full detail to the directors of each bank examined. His reports to the directors are just such as competent accountants would make were they employed by the directors to make examinations. In this way each bank has the advantage of having an examination by a competent examiner made expressly for the directors of the bank.

Besides this the examiner makes a general report to the Clearing House Committee on the conditions found by him, drawing special attention to any depreciated assets, any irregularities or anything in the institution open to serious criticism.

In the event of conditions being sufficiently bad to warrant it, the committee has the right to a perusal of the detailed report made to the directors, a copy of which the examiner keeps in his own file.

The committee, however, as you understand, does not call for this except in an urgent case when the thing is very bad and they want to get right to the bottom of it; they simply act on the general report that they receive from the examiner.

On the basis of this general report, if there is anything to criticize the committee gets into touch with the directors of the bank through its president, and in as diplomatic a way as possible has all matters open to criticism satisfactorily explained or corrected.

Each bank is still required to send to the committee a copy of the reports made to the Government on the call of the Comptroller of the Currency or the State Auditor, as the case may be. These are taken up and considered by the Clearing House Committee from the standpoint of the last examination made to it by the Clearing House Examiner. The committee may decline to pass such statements as satisfactorily until all matters criticized in the examiner's report are shown to have been corrected or provided for.

Thus you see in addition to the special report made to the committee by the examiner after he has made an examination we have five reports rendered by the banks themselves, and our corrective method is that after we have received a report from the examiner, unless everything is satisfactorily explained, we will not pass favorably on the next report rendered by the bank itself as being a true statement of its condition unless the matters objected to or criticized have been corrected.

The rule that guides the committee is a simple one and is applied without fear or favor to all banks alike. It requires that the statements of the banks as published and as rendered to the clearing house must divulge their true condition, which means that their assets at a far and reasonable valuation will offset their liabilities, including their capital, surplus and undivided profits.

The great advantage of the clearing house examination is that its committee is composed of local banks who are posted on local credits and are familiar with or can easily ascertain the value of local securities. Government authorities, either national or State, have no power to interfere otherwise than by criticism until conditions become so bad that the capital of a bank is materially impaired or its insolvency questioned.

Now that, you can see, is very different from the attitude of the clearing house represented by the committee towards the statement. If the statement does not show a true condition of existing affairs the clearing house interferes. The Government interferes if the conditions become so bad that the capital is impaired, which is a very different story. A bank might advertise as much surplus as capital, and so long as its capital is not impaired the Comptroller has no right, by law, to interfere.

The clearing house, having authority to discontinue clearing house privileges to any bank whose condition for any reason whatever is not satisfactory to its committee, has a leverage that, as a rule, checks its members up before conditions become serious with any of them. There are about sixty banks connected with the association and the examiner can only get round them once a year. Of course, matters may go very far wrong in a year, but where it is deemed necessary special examinations can be made at shorter intervals.

Such are the methods adopted by the Chicago Clearing House Association. They have worked out so far with unqualified success. There has been neither friction nor unpleasantness. Bank directors realize the great benefits derived and are unstinted in their praise of them. They are greatly assisted by them in keeping themselves posted on the condition of their banks and they readily co-operate with the Clearing House Committee in the correction or elimination of anything open to criticism.

Our methods insure the stirring up and elimination of the sediment which is liable to accumulate in the banks. I am in the habit of classifying bank assets in dairy terms, such as cream, sweet milk, skim milk, sour milk and sediment. In the bank, as in the dairy, the sediment falls to the bottom, where it remains out of sight and out of mind unless constant vigilance is exercised in its elimination. If a bank's management is weak the cream is liable to be skimmed off the top, while the sediment accumulates at the bottom, and gradually its assets become so permeated with it that they form a putrid mass of curds only fit for the dump pile of a receivership. Clearing house examinations tend

to the healthful conservation of the sweet milk and cream and to the elimination of the sour milk and sediment. If there are any points that occur to any of you gentlemen that have been covered by our experience I will be glad to answer any questions that you may ask. (Applause.)

THE PRESIDENT: Gentlemen, the subject that has just been discussed by Mr. Forgan is of such great importance, and we have left a space on our program, should anyone desire to ask any questions, or discuss it, or give any experiences of their own, we would be glad to hear from them, and if not we will proceed with the regular program.

MR. SHORROCK: I would like, Mr. Chairman, to say that the plan which Mr. Forgan has suggested is easy for the large cities, where it is possible for them, with a minimum expense to themselves, to obtain a man who fulfills all the requirements of the position. Now, such an examination, it has occurred to me, like any other examination, is only of value proportionate to the caliber of the man who makes it. You take a small city and it may be said, I think, without contradiction, that it would be a burden upon the banks out of all proportions to the burden which will be imposed upon the banks of a city like Chicago, and the system would be a failure, because the man who could be paid by an assessment upon the bank, let us say an assessment on each bank in Chicago, would not be of the caliber that is to be desired. Now, it is to be remembered, according to the plan which is at present adopted, that the person in charge of the examination really has, as I understand it, to fulfill two requirements. He must not only be a competent accountant, but he must also be a good judge of securities and collaterals. It may be easy to find one and easy to find the other, but it is difficult to find a combination of the two unless in the case of the man who would require quite a high price for his services. Now, it occurs to me, to ask, in throwing out that general question for consideration, whether the benefits to be derived from such an examination, according to the experiences of the clearing houses which have adopted it, depend mostly upon the accountant's part of it or mostly upon the judgment and knowledge of the examiner as to the value of assets. If the former, one set of conditions would arise, and if the latter another set.

Now, I can quite conceive of a man being found or a committee being found in any city, however small, which would be able to pass readily and intelligently upon the assets of the bank. That would involve a great deal less expense because it would not involve the very close and careful examination of the books such as an accountant might make. It is a question whether, in endeavoring to carry out this general program on the part of this section, a recommendation to smaller cities would not quite fulfill the intent or pretty nearly fulfill the intent of the plan, if the clearing houses themselves, not appointing an examiner in the full sense of the term which Mr. Forgan has used, appointed a man, or two or three men, before whom should come in the process of examination, the assets of the bank, whether securities or loans. The question I would like to put to Mr. Forgan, and ask him is whether some such plan might not fill the bill in the case of cities which might not feel justified in incurring the expense of a man who would fulfill the double function of an accountant and of a judge of assets.

THE PRESIDENT: Mr. Forgan will kindly answer the question.

MR. FORGAN: Mr. Chairman, of course anything that I might say in answer to the gentleman's question in regard to the smaller cities would not be based on experience, except from the fact that, in my career, I have been a bank inspector, as it is called—it is the same as an examiner. When I was bank inspector I found no difficulty whatever in going into any moderate sized bank or locality and, by judicious inquiry and talking over matters with the bank management, and in the case of our banks we could have consultation with the directors, calling the directors together and going over with them the matter, the trouble usually being that the management of the bank is left to an individual, and the directors are not fully posted as to what is going on. The examiner brings information to the directors, and in his examination he would have a meeting of the directors and go over the work and put the responsibility up to them to see that their officers are making the right kind of loans. Of course, I can conceive of a bank examiner going into one part, perhaps smaller outlying banks, with the same experience of the National Bank examiners, who would go in and

tell the president of the bank that he would like to meet the directors. The president said to him: "What do you want to meet the directors for?" "Why, I would like to go over the assets with them and see what they know about the people to whom you have been making loans." He says, "You must not do that. I could not stand that." The examiner said, "Why not?" "Why," he said, "about five years ago a bank examiner came around here and did that thing. Now, my directors are composed of a couple of merchants in the town here and eight or nine wealthy farmers around the district, and they are depositors on whom I rely for my deposits, and when the bank examiner showed them the conditions they very promptly went and proposed to my customers that they would loan the money direct, and instead of getting three per cent. from the bank they got six or eight per cent. from the farmer;" and he said: "It came mighty near winding up the bank." Any such conditions as that might occur once in a while. That is suggestive of what might occur in the smallest localities. But it seems to me that any difficulty of that kind could be overcome if banks would group in sections and these groups elect a committee of responsible men among the directors for each locality with whom the bank examiners could consult in the same way that they consult with the clearing house committee in Chicago. If our bank examiner in Chicago goes into a bank and finds anything he does not know about, in the first place he refers to the mercantile agency and he finds out all he can from that, and then he has the credit departments of all the banks in Chicago at his disposal, and he has the committee to consult with, not necessarily in session. He is the examiner of the bank and he comes over and wants to know what you know about such and such clearing, or such and such a man, without telling us what his reason for it is, and we give it to him to the best of our information, and then he becomes informed, and the longer he is at it the more he knows about it. I think if the banks of the country were put in groups it would be well worth trying, anyway. If they were, all that would be necessary would be to get a man of ordinary intelligence and knowledge of the banking business to make the examination and to have a committee with

whom he could consult, so that the whole responsibility would not remain on him, as to the desirability of any asset in the bank or as to the credit of any borrower, and the expense to be shared from the business of the bank. The examiner's department works in entire accord with and assists the National Bank examiner, and the National Bank examiner assists them. They consult together, and if it is necessary we can get the correspondence under control of the State Comptroller so we can get together in that. We find that both the Comptroller's department and the State Auditor's department are very glad of any suggestions the clearing house committee deem to make with regard to any desire or thing to be done in connection with anything that is wrong in any of the banks of the community so far as the committee of directors is concerned; in Chicago we have not heard anything about that, so far as I am aware. I think we find that banks after they get to a certain size that the examination can better be accomplished by the directors appointing competent auditors to do the work for them, and I think that wherever the Comptroller finds that there is an auditor who is appointed directly by the directors to make an examination for them and on their behalf, and over the heads of the president or any of the other officers of the bank, and that the report comes direct to the directors from the auditor and makes it personal from the board, he does not consider that. A very important thing has been suggested to me in regard to that, and I should have mentioned it in my introductory remarks. Our examiner, when he has made a report, notifies every director in the bank examined that the report to be made is of such a character and his report in every detail filed with the president of the bank, and requests them to produce the report and to acknowledge receipt of this notice and notify him of the consequence, so that the director does not participate in the performance of his duty any more than the officer does. That we find to be a very important thing.

A Member: I would like to ask this question. In most of the States there is more or less jealousy between the bankers, and in adopting this system what has been the result? The tendency has been to that jealousy and feeling for fear that one

bank would discover the condition of the other banks. What has been the result of the jealousy that usually exists between banks in cities?

Mr. Forgan: I will say in regard to that, that our experience has been, perhaps, exceptional. We have never seen the slightest sign of any question being raised as to the correctness of an examiner's report, or that his report was anything but intentionally correct, and that the criticism of the clearing house committee based on it has been just and equitable, and instead of increasing jealousies it has given us a sort of a brotherhood. We are working under what might be called a gentlemen's agreement, and we are all pledged to the same thing, that we will keep our banks open to an examination and in such condition that they can be examined, and there is not a single bank that has been examined that has not expressed the greatest willingness to put themselves in the exact position that the clearing house committee has thought they should; and we have got nothing but thanks in every instance. I will be exactly truthful. We did have one. A board of directors did say that we had been unnecessarily severe. But that exception proves the rule, and I wish to say this, that in regard to that bank, to-day there is not a bank in the city of Chicago that has so profusely and so strongly thanked the committee, the clearing house committee and the bank examiner for what they said and what they did and what they have accomplished through the advice given. The strongest supporter we have to-day is the only one that ever objected. (Applause.)

Mr. Jess: Mr. Chairman, in Los Angeles we maintain a special clearing house examiner, as does our sister city, San Francisco. And to give our testimony as to the efficacy and desirability of the system of the clearing house in all our cities, naming special examiners, we feel that the services that have been rendered have been most efficient. We believe that bankers know more about the conduct of the banks in their cities than do government examiners, in a general way. We can put our fingers on the inconsistencies at all times. We can know ourselves where we should make examinations, both to the interest of the bank that is perhaps being run injudiciously and to the

advantage to the other financial institutions of the city, and to the interest of the entire city. I wish to say this, that I think will be of interest to you. I see no reason why this system which has been so satisfactory to the clearing house banks cannot be extended and wisely extended for taking in other banks in the whole length and breadth of our land. In California we formed a tentative organization of the banks of our entire State with the idea of having a central committee, districting the State into districts and having clearing house examiners or examiners supported by the banks to examine every bank throughout the State. I think that any State can be so organized and maintain a special examiner at all times, who will have the advice of a central committee, and who would have the whole matter in charge. I can see no reason why such a beneficent system should not be extended to all the banks in every city in the Union. (Applause.)

Mr. Forbes: I would like to ask Mr. Forgan's opinion on just one point; that is the employment of an examiner; whether or not he would consider a special examiner for a city or community who devotes his entire time to that community, regardless of whether he may be of ordinary ability or not, as compared with employment by an auditing firm who makes these examinations. It is getting to be customary for auditing committees to do this work. I would like to know whether or not he would consider the services of a man who would do nothing else, even if he were only paid a thousand dollars a year, as compared with running one of these mercantile concerns.

Mr. Forgan: I think, Mr. Forbes, the clearing house, or the group examiner employed by the bank, having a committee to consult with, is preferable to an outside examination by these auditing companies. I will say that, notwithstanding I am interested and a director of these auditing companies, and I am talking a little bit against my own pocket, perhaps, as I should like to get that sort of business. I would not, however, for one minute depreciate the audit made by a competent auditing company, because they employ good accountants and they make a very thorough examination, and very frequently, so far as the internal working of the bank is concerned, they make a great

many good recommendations. But when it comes to credits, I think that a man employed by the association and having the confidential advice of every member of that association, and who is judicious in his efforts to obtain the information, is the proper way. He can go to anyone in it and ask about John Smith. He does not have to say that John Smith has a note for $2,500. All he has got to do is to make the ordinary inquiries around and get more than one opinion about the man he is investigating about, or the security, whatever it is. Now, he has access to all the members of the association, either a clearing house or a group. He can consult with them, and that is the way we get our information ourselves. We consult with each other. And he has us all to consult, whereas, when an auditing company goes to work to send out men who are apparent strangers to the community, of course, and when he comes in he might explain he wants the information because he is examining the bank, but he would not be as liable to get as strictly frank and straightforward information, perhaps, because they would say, "I don't know what he is investigating for. I don't know what he wants of it." Anyway he would not get in touch with them. He would not get in touch with the other members of the association outside of the one he was examining in the same way that an employee of the association would, where everybody felt that, in order to have things done right, he is bound to examine properly in regard to any question he wants to ask. Therefore, to that extent, without the slightest degree waiting to reflect in any way upon an audit company's examination, which is an excellent thing to have, I would say that I personally prefer the examiner employed for the purpose by an association among themselves, who has the committee of the association to deal with and to consult with, and has all the members besides to consult with, and they naturally would give him the best information they would have.

The President: Gentlemen, we have thirty minutes before the noon recess, and if it is agreeable to you we will devote that time to a discussion on any of the matters which have been discussed up to the present time. That is, if there are any questions which you desire to be asked concerning the making of clearing

house reports, or the numbering and lettering of banks, or any of the subjects referred to in any of the reports, that thirty minutes will be very well devoted to that purpose.

(It was moved that a vote of thanks of this Section be given Mr. Forgan for his paper on "Clearing House Examinations by Clearing House Examiners." Seconded and duly carried.)

Mr. Thralls: I just want to make a few remarks with regard to the expense of examination. Some of the gentlemen seem to be afraid of that on account of the expense of special examiners. We have tried the system for three years, and I don't think there is a man in our city who would not be glad to spend three times what we are spending for the examination.

Mr. McIntosh: We have a system of clearing house examiners modelled somewhat on the Chicago plan, but with slight modifications, which I think answer some of the objections that seem to be in the minds of some of the members, more particularly that of secrecy and possible jealousies that might arise by reason of the knowledge of the intimate affairs of each bank, or at least known to a committee which is subject to change at annual elections. Our examiner there was chosen by reason of his knowledge of credits of the city and his fitness as a bank manager. He reports to the clearing house committee only such factors in relation to the examinations that he has made which, in his judgment, threaten loss or show unsound methods or unconservative methods. He does not report to us, if he has examined the First National Bank of our city, anything except that he has examined that bank and finds its conditions satisfactory. We know nothing of the details. Our first object is to the depositor and not to the stockholder. We regard our first responsibility to the depositor, and if there is a minimum of shrinkage in a bank amply strong, that fact is not reported to the clearing house committee. But he is instructed—not only authorized but instructed, and of necessity must report to our committee any factor in relation to the examination he thinks threatens the solvency of the bank, in case of unsoundness of conduct of a tendency toward a line of conduct which would ultimately bring the bank into difficulties. But in the meantime

there is nothing reported to the clearing house committee of any detail in connection with the management of the bank, which I think is objectionable to banks in a city dealing in intimate affairs.

The President: As I understand from Mr. Forgan, that is the identical course pursued in Chicago. There is no report made to the clearing house committee unless some serious results develop. The result of that examination is reported to the particular bank that has been examined and their attention called to it. So there is practically no difference between your method and that in Chicago.

Mr. Forgan: With this additional idea: that in Chicago, if things are very bad, and are reported to be generally bad, if the sediment gets so near the top that the thing is dangerous all the way through, then the clearing house committee has the right to get from the examiner his detailed report. But, in doing so, they notify the bank that they are doing so, and then they have a meeting of the directors with them, or a committee of the directors, and they go over the whole thing.

Mr. McIntosh: It was my impression, after speaking to some of the members of the Chicago Clearing House Committee, that more complete details in each report were given, given, perchance, on Mr. Forgan's own bank. An asset was carried a little higher than it should be. That would not be reported.

Mr. Forgan: Yes. For instance, you take the bond account of any bank. If there was a large depreciation in the bonds it would be shown by the market value being quoted by the examiner and the deficiency shown the committee. But that is nothing more than the bank would be required to do five times a year in its own statement.

Mr. McIntosh: Does your committee criticize an individual loan, that, in its judgment, may not be desirable from the standpoint of the bank? And is it presented to you, whether it threatens the bank or not?

Mr. Forgan: Yes, slow loans are reported. Slow and excessive loans are picked out and listed.

Mr. McIntosh: If our examiner finds any excessive or slow loans he takes them up to the directors of each bank. If he is unable to work it out he then brings it to the committee. He does not report to us that the First National Bank, or in the Second National Bank, he has found a slow loan or he has found a loan which, in his judgment, is excessive. He corrects it with the bank itself, and only those things which threaten the soundness of the conduct, as a principle, does he report.

Wynkoop Hallenbeck Crawford Co. New York

UNIVERSITY OF ILLINOIS-URBANA
3 0112 057572411